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DEPARTMENT OF STATE REVENUE
CONSOLIDATED LETTER OF FINDINGS

97-0209, 97-0210, 97-0211, 97-0212, 97-0213, 97-0214 ST

Sales and Use Tax
For The Period: 1992-1995

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Departments official position concerning a specific issue.

ISSUES

I. **Sales/Use Tax** - Software Licensing and Maintenance Agreements

Authority: IC 6-2.5-2-1; IC 6-2.5-3-2; 45 IAC 2.2-4-2;
Information Bulletin #8, Sales Tax (February 1990);
Information Bulletin #2 Sales Tax (August 1991).

Taxpayer protests the imposition of use tax on its software licensing agreements.

II. **Sales and Use Tax** – Promotional Materials

Authority: IC 6-2.5-3-1; IC 6-2.5-3-2; IC 6-2.5-5-36;
Miles, Inc. v. Indiana Department of State Revenue, 659 N.E.2d 1158 (Ind.Tax 1995);
USAir, Inc. v. Indiana Department of State Revenue, 623 N.E.2d 466 (Ind.Tax 1993).

Taxpayer protests the imposition of use tax on promotional materials.

III. **Sales and Use Tax** – Boilers and Related Equipment

Authority: 45 IAC 15-3-2;
Commissioner's Directive # 3 (April 15, 1986).

Taxpayer protests the imposition of use tax on its certified resource recovery system.

IV. **Sales and Use Tax** – Lump Sum Contracts

Authority: IC 6-2.5-8-8; 45 IAC 2.2-3-8; 45 IAC 2.2-3-9.

Taxpayer protests assessments of use tax on construction items used by contractors in completing lump sum contracts.

V. **Sales and Use Tax** – Service and Maintenance Agreements

Authority: None

Taxpayer has provided the Department with Agreements that Audit has not reviewed.

VI. **Sales and Use Tax** – Energy Center

Authority: IC 6-2.5-4-5; IC 6-2.5-5-5.1.

Taxpayer protests assessment of use tax on payments received for the provision of energy.

VII. **Sales and Use Tax** – Storage and Transportation of Work-in-Process

Authority: IC 6-2.5-5-3; 45 IAC 2.2-5-8;
General Motors v. Dept. of State Revenue, 578 N.E.2d 399 (Ind.Tax 1991).

Taxpayer protests the denial of industrial exemptions for equipment and supplies used in the storage and transportation of "work-in-process."

VIII. **Sales and Use Tax** – "Production" Equipment

Authority: IC 6-2.5-3-2; IC 6-2.5-5-3; IC 6-2.5-5-5.1;
45 IAC 2.2-5-8.

Taxpayer protests the imposition of use tax on "production" equipment.

IX. **Sales and Use Tax** - "Sharpening" Tools and Equipment

Authority: IC 6-2.5-5-3; IC 6-2.5-5-5.1;
Rotation Products Corp. v. Indiana Dept. of State Revenue, 690 N.E.2d 795 (Ind.Tax 1998).

Taxpayer protests the imposition of use tax on tools and equipment.

X. **Sales and Use Tax** - Safety Equipment

Authority: IC 6-2.5-5-3; 45 IAC 2.2-5-8.

Taxpayer protests the imposition of use tax on its purchases of "safety equipment."

XI. **<u>Tax Administration</u>** - Penalty

Authority: IC 6-8.1-10-2.1; 45 IAC 15-11-2

Taxpayer protests imposition of the ten percent (10%) negligence penalty.

<u>STATEMENT OF FACTS</u>

Taxpayer (the Parent Corporation and its five (5) Subsidiaries) manufactures and markets a variety of consumer products. As a result of Sales/Use tax audits for the period July 1, 1992 through June 30, 1995 *(separate audits were conducted for each entity*), proposed assessments were made against Taxpayer. These assessments are now under protest.

The Parent has requested these six (6) protests be consolidated for purposes of hearing and resolution. The Department, when appropriate, may refer to any member(s) of the consolidated group as "Taxpayer." Additionally, "Parent," "Subsidiary," and "Affiliate" will also be used to refer to members of the consolidated group.

I. **<u>Sales/Use Tax</u> - Software Licensing and Maintenance Agreements**

<u>DISCUSSION</u>

Taxpayer entered into software licensing and maintenance agreements with two software developers/vendors ("**Vendor A**" and "**Vendor O**"). The agreements covered both the use and maintenance of Vendor software. As Taxpayer failed to pay sales tax at the time of acquisition, Audit assessed use tax on these licensing and maintenance agreements. Taxpayer argues the assessments are invalid as Audit is attempting to impose sales/use taxes on "customized" software—a position contrary to Department policy.

Licensing Agreements
Taxpayer entered into a licensing agreement with Vendor A. Taxpayer contends Vendor A's licensed software represents exempt "customized" programming. Taxpayer explains:

> This software developed by [Vendor A] was: (i) designed specifically for [Taxpayer]; (ii) was not developed for sale or lease on the general market; and (iii) was not sold or leased on the general market. In fact, this software, because it was customized to meet [Taxpayer's] unique needs, was not used by any prior [Vendor A] customer. The extent of the time and effort required to design custom software for a company the size of [Taxpayer] is dramatically evidenced by [Vendor A's] investment in this project. [Vendor A's] employees spent over a year designing and installing this software for [Taxpayer]. After installation, [Vendor A's] employees continued to

> work on the software because it did not conform to [Taxpayer's] specifications.

Taxpayer also licensed two types of programs from Vendor O—**Full Use Programs** and **Deployment Programs**. Taxpayer and Audit both agree the Full Use Programs represent taxable "canned" software.

Taxpayer asserts, however, that the Deployment Programs were "[d]esigned developed, and customized to meet [Taxpayer's] unique and specific needs and were not previously usable, or used, by any other clients [of Vendor O]." As such, these programs represent exempt "customized" software.

Audit based its assessment on IC 6-2.5-3-2, which provides for the imposition of use tax on the "[s]torage, use, or consumption of tangible personal property in Indiana, if the property was acquired in a retail transaction…"—unless, of course, an exemption applies. Furthermore (and more germane to the taxation of computer software), the Department's *Information Bulletin #8, Sales Tax* (February 1990), states in part:

> As a general rule, transactions involving computer software are not subject to Indiana Sales or Use Tax provided the software is in the form of a custom program *specifically designed* for the purchaser….Pre-written programs, not specifically designed for one purchaser, developed by the seller for sale or lease on the general market…are subject to tax *irrespective of the fact that the program may require some modification for a purchaser's particular computer* (emphasis added).

Audit determined Vendor A's software and Vendor O's Deployment programs had been "developed…for sale or lease on the general market," and therefore, were subject to tax. Audit maintains all software modifications occurred *after* the software had been acquired by Taxpayer. Consequently, Audit proposed assessments of use tax on the licensing of the software, but not on any of the subsequently provided programming services.

The site license Taxpayer purchased from Vendor A was for a flexible, comprehensive, component-based business application software package. According to the licensing agreement, Vendor A included the following business application modules in Taxpayer's software package:

- Inventory Management System
- Manufacturing Standards Data Base
- Purchasing
- Material Requirements Planning
- Master Schedule
- Shop Floor Control
- Capacity Requirements Planning
- Configurator
- General Ledger
- Accounts Receivable

- Accounts Payable
- Order Entry and Invoicing
- SQR

Vendor A's software was designed to operate in a specific software environment (i.e., a specific relational data base management system), which Taxpayer licensed from Vendor O.

On July 30, 1993, Taxpayer and Vendor A entered into a "Standard License and Maintenance Agreement." Paragraph 4.1 of the agreement cautioned:

> Unless a separate written Custom Programming and Services Agreement has been signed by the parties, the parties do not contemplate that [Vendor A] will undertake to create any modifications to the Licensed Program for use by Licensee [i.e., Taxpayer]. If the parties have executed a Custom Programming and Services Agreement, then the creation and use of modifications to the Licensed Program shall be governed by the terms of such agreement.

Concomitant with execution of the "Standard License and Maintenance Agreement," Taxpayer and Vendor A entered into a "Custom Programming and Services Agreement" (CPSA). The CPSA represented a contract between Taxpayer and Vendor A for future programming and design services—services to be provided by Vendor A and billed at the daily rate of $1,080.00.

The nature of the licensed software, as well as the terms of the agreements, strongly suggests Taxpayer licensed a *standard* business application software package—i.e., the "Original [Vendor A] Application Software." But to modify this "original" software, Taxpayer and Vendor A entered into another agreement, the CPSA, to create "Modified [Vendor A] Application Software" as well as "Hybrid Work." Audit's proposed assessments apply only to the "original software," and not to any subsequently provided programming and design services.

The Department believes that Vendor A's software represents "canned," pre-written business application software which is available to all—even though the software was subsequently "modified" to meet Taxpayer's specific needs. But even "modified," in this context, is not synonymous with "customized." Software can be "modified" in many ways - ranging from the selection of setup, installation, and configuration options to the "writing" and "rewriting" (regardless of methodology used) of source code. Only the latter (i.e., "writing" and "rewriting" source code) represents the creation of "custom" software.

Custom software (or programming) represents a professional service rendered pursuant to 45 IAC 2.2-4-2. (Also see *Information Bulletin #8, Sales Tax.*) Modifications and additions to the original source code - changes made specifically for Taxpayer - represent custom programming services; and as such, are not taxable. However, any "modification" or "customization" performed on software **after its purchase** will not transform taxable, "canned" software into exempt, "customized" software. The Department finds Taxpayer's licensing of the "Original [Vendor A] Application Software" to be a taxable transaction.

With regard to Vendor O's Deployment Programs, "Amendment 2 to the Software License and

Services Agreement between [Taxpayer] and [Vendor O]" (effective August 27, 1993) contained the following terms:

> **1.2 LICENSE TYPE**
>
> "Full Use Programs" are defined as an unaltered version of the Licensed Programs with all functions intact.
>
> "Deployment Programs" are limited to use solely in conjunction with and in support of internal Client Application(s) ("Client Application(s)") and as restricted below. The combination of the Deployment Programs and a Client Application shall be defined as the Application Package.
>
> a. The Application Package under Client Application control may be used to create new tables or alter tables only to the extent necessary to implement the Application Package's functions. The Application Package may not allow use of the Deployment Programs' Create or Alter commands or any other command that would allow the User to create tables or alter tables outside the scope of those necessary for the operation of the Client Application(s).
>
> b. The Deployment Program's in the Application Package may be used by Users of the Deployment Programs for query and data entry only.
>
> c. The Deployment Programs shall not be used outside the scope of the Application Package(s).

The chosen terminology describes limited use software which collectively operate as an interface between Taxpayer's existing application programs and Vendor O's Full Use Programs. Such utility and context suggest attributes of "custom" software. The Department concludes, therefore, the licensing of Vendor O's Deployment Programs does not represent a taxable transaction.

Maintenance Agreements

Taxpayer purchased optional software maintenance agreements from **Vendor A** and **Vendor O**. Taxpayer did not pay any sales tax or self-assess use tax on these transactions. Audit, therefore, proposed assessments of use tax on Taxpayer's purchases.

Optional warranties and maintenance agreements, generally, are not subject to Indiana sales tax. "However, if the [optional warranty or maintenance] agreement includes a charge for property to be periodically supplied, the agreement would be subject to tax." In the context of optional software maintenance agreements, the distribution of program updates represents "property to be periodically supplied." *Information Bulletin #2, Sales Tax* (August 1991).

Taxpayer's maintenance agreements with **Vendor A—**"Standard License and Maintenance Agreement" and the "Custom Programming and Services Agreement"**—**contain similar language. The "Standard License and Maintenance Agreement" reads, in part:

> This Maintenance Agreement, and the Annual Maintenance Fee, shall cover routine 'bug fixes', troubleshooting, advice and assistance, *and such modifications enhancements and updates of the Licensed Program as [Vendor A], at its option, may elect to offer its Licensees. The Annual Maintenance Fee* ***shall not entitle Licensee to receive any substantial modifications or updates of the Licensed Program****,* specifically including but not limited to modifications that may be made by (Vendor A) because of changes in the System Hardware, Operating System Software, or the (Vendor O) Environment (emphasis added).

Taxpayer also entered into a "Software License and Services Agreement" with **Vendor O**. Taxpayer explains:

> [Taxpayer] agreed to pay Vendor O for "**Basic** Technical Support services" pursuant to Section 6.1 of the agreement…. [Vendor O] did not agree to provide software updates pursuant to Section 6.1, and, consistent with the agreement, [Vendor O] did not provide any updates to Taxpayer in exchange for these maintenance service payments.

Since Taxpayer's optional software maintenance agreements with Vendor A and Vendor O do not include the right to receive program updates—or any other tangible personal property—the agreements, consistent with IC 6-2.5-2-1 (imposition of sales tax), IC 6-2.5-3-2 (imposition of use tax), and *Information Bulletin #2, Sales Tax* (August 1991), are not subject to Indiana sales and use taxes.

FINDINGS

Taxpayer's protest is sustained to the extent assessments were made on its licensing of Vendor O's Deployment Programs and its purchase of service and maintenance agreements from Vendors A and O. Taxpayer's protest is denied, however, on assessments based on its licensing of Vendor A's software.

II. Sales and Use Tax – Promotional Materials

DISCUSSION

Audit assessed use tax on the Subsidiaries acquisition of promotional items and advertising materials "purchased" from both in-state and out-of-state vendors. Taxpayer engaged vendors to provide **(1)** design and layout "services" (i.e., camera-ready art) for its advertising literature. Additionally, Taxpayer acquired a variety of **(2)** promotional materials from disparate sources. All materials acquired were transported to Taxpayer's Graphics Distribution Center prior to distribution. Audit explains:

> [Two of the Subsidiaries'] sales divisions purchase various promotional items which are delivered to the…Distribution Center…where they are collated and redistributed

> to salesmen and dealers in Indiana and across the country. These items include brochures, catalog sheets, price lists, etc., purchased from outside vendors both within and without Indiana. Other promotional materials distributed in the same manner include various, which are primarily purchased from the…[Parent's] manufacturing companies. The promotional items are all distributed free of charge.

Audit estimates approximately 97.5% of Taxpayer's promotional items and advertising materials were shipped out-of-state for use outside Indiana. Audit, therefore, assessed use tax on 2.5% of Taxpayer's purchases of promotional materials from non-Indiana vendors. However, Audit assessed use tax on 100% of Taxpayer's purchases from Indiana vendors. Taxpayer protests 97.5% of these Indiana assessments.

"An excise tax, known as the state gross retail tax [i.e., sales tax] is imposed on retail transactions made in Indiana." IC 6-2.5-2-1(a). A complementary excise tax, "known as the use tax, is imposed on the storage, use, or consumption of tangible personal property in Indiana, if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that transaction." IC 6-2.5-3-2(a). "Storage," as used in IC 6-2.5-3-2(a), **"means the keeping or retention of tangible personal property in Indiana for any purpose except the subsequent use of that property solely outside Indiana….** The complementary formulation exists to ensure non-exempt retail transactions that escape sales tax liability are nonetheless taxed." *USAir, Inc. v. Indiana Department of State Revenue,* 623 N.E.2d 466, 469 (Ind.Tax 1993) (*"USAir II"*).

(1) Camera-ready art

Taxpayer characterized some of its purchases as follows:

> [A sales subsidiary of the parent corporation] utilized out-of-state companies to perform design and layout for advertising literature and promotional materials (such as brochures, catalog sheets, and price lists). [The subsidiary] then had "camera ready" art delivered to Indiana printers who performed the printing services. [The subsidiary] owned the art at all times.

Taxpayer contends the acquisition of camera-ready art should be exempt from sales and use taxes because "commercial printing and binding has long been recognized by the Indiana Supreme Court to be a service business, not the sale of property."

IC 6-2.5-5-36 provides for the following exemption:

> Transactions involving tangible personal property acquired by a person that has contracted with a commercial printer for printing are exempt from the state gross retail tax, if the property is acquired for use at the commercial printer's premises and the commercial printer could have acquired the property exempt from the state gross retail tax and use tax.

As added by P.L.70-1993, Sec, 3, retroactive to January 1, 1993.

The Department finds that Taxpayer's camera-ready art purchased after December 31, 1992, and subsequently sent to an Indiana commercial printer, is exempt from Indiana sales and use taxes. As for Taxpayer's camera-ready art prepared prior to January 1, 1993, no such exemption exists.

(2) Other promotional materials

Taxpayer acquired, exempt, other promotional items and advertising materials from both Indiana and non-Indiana vendors. As 97.5% of these items were eventually distributed out-of-state, Taxpayer did not self-assess use tax on 97.5% of these purchases. Audit approved this exclusion for out-of-state purchases, but not for Taxpayer's Indiana purchases. Audit proposed assessments on 100% of Taxpayer's Indiana purchases. Taxpayer contends exempt treatment is justified for both Indiana and non-Indiana purchases.

Specifically, Taxpayer argues that pursuant to IC 6-2.5-3-2 (excise tax imposed on the "storage, use, or consumption of tangible personal property"), and IC 6-2.5-3-1(b) ("'[s]torage' means the keeping or retention of tangible personal property for any purpose **except the subsequent use of that property solely outside Indiana**"), 97.5% of its Indiana purchases should also be exempt from use tax (emphasis added).

In this instance, Audit proposed assessments of use tax because Taxpayer failed to pay sales tax on non-exempt Indiana purchases. While the vehicle for the collection of sales tax delinquencies is proposed assessments of use tax, liability derives from Taxpayer's failure to pay a validly imposed sales tax. Taxpayer may not invoke use tax exemptions for purposes of avoiding its sales tax responsibilities. Use tax exemptions were not created to provide amnesty for sales tax transgressions.

FINDING

Taxpayer's protest is partially sustained and partially denied.

III. Sales and Use Tax – Boilers and Related Equipment

DISCUSSION

Audit proposed assessments of use tax on a percentage of Taxpayer's boiler equipment, repair parts, boiler chemicals, and other consumables associated with the operation of several boilers purchased during the audit period.

Taxpayer contends the assessments are invalid as they contravene conclusions reached by the Department in prior letters of findings issued to Taxpayer and conflict with findings reached in prior litigation.

Taxpayer explains:

> [Taxpayer's…] collection system, certain boilers and [Taxpayer's] energy center were certified as a resource recovery system [by the Indiana Department of Environmental Management]. This system is also part of the manufacturing process. The dust collection system, which includes bins, was considered to be part of the manufacturing process in the previous letter of findings issued to [Taxpayer] and in [the findings of an Indiana court in a case in which Taxpayer participated as Appellee-Plaintiff].

Audit, familiar with Taxpayer's argument, responds:

> The [T]axpayer feels the … boilers are 100% exempt due to being certified as a Resource Recovery System for property tax purposes. … The current Department policy does not allow an exemption for boiler equipment due to [the equipment] being certified as a Resource Recovery System. This is consistent with the first Letter of Findings on the last audit, which stated the predominate purpose for using the … boilers is cost savings, not for environmental concerns or requirements. There is no existing exemption under Indiana Sales Tax Law relating to Resource Recovery Systems.

Previously, the Department has allowed Taxpayer an exemption for IDEM certified resource recovery systems. However, in a letter of finding ("LOF") dated March 23, 1992, the Department denied Taxpayer a sales/use tax exemption for these resource recovery systems. This denial was "overturned" by the Department in an "adjustment letter" sent to Taxpayer on October 15, 1992. To wit:

> Boiler related purchases at [Taxpayer's] other manufacturing facilities are exempt to the extent the boiler and related equipment ha[ve] a timely Resource Recovery Certification.

Letter to Taxpayer, October 15, 1992.

Given the Department's previous correspondence with Taxpayer—and consistent with 45 IAC 15-3-2, and *Commissioner's Directive #3*, revised April 15, 1986—any revocation or modification by the Department of a ruling previously issued to Taxpayer cannot be retroactively applied.

Therefore, to the extent the Department can verify that the Indiana Department of Environmental Management (IDEM) certified Taxpayer's sawdust collection system, certain boilers, and its energy center as resource recovery systems, Taxpayer may claim the exemption.

However, no legal basis exists to support such an exemption for tangible personal property certified by IDEM as a "resource recovery system." For sales/use tax exemption purposes, utility is determinative. The tangible personal property must be used in an exempt manner. (See IC 6-2.5-5-30, exemption for equipment used to comply with "environmental quality statutes, regulations, or standards;" and IC 6-2.5-5-3, machinery tools and equipment directly used "in the direct production…of other tangible personal property.")

Consequently, Taxpayer may no longer rely on any previous rulings to the contrary, which are hereby revoked.

FINDING

Taxpayer protest is sustained.

IV. Sales and Use Tax - Lump Sum Contracts

DISCUSSION

Audit assessed use tax on tangible personal property purchased by Taxpayer. The property was subsequently incorporated into real property. As justification for the imposition of use tax, Audit cites 45 IAC 2.2-3-8(a), which states in part:

> The conversion of tangible personal property into realty does not relieve the taxpayer from a liability for any owing and unpaid state gross retail tax or use tax with respect to such tangible personal property.

Audit described Taxpayer's taxable transactions in the following manner:

> The taxpayer contracted with local contractors to perform lump sum improvements to realty concerning building expansions & improvements, including a retrofit of the overhead plant lighting….**On some of these contracts, the contractor had an exemption certificate on file and exempted all of the construction materials on these jobs.** The contractors have submitted material cost breakdowns to the taxpayer for the jobs in question (emphasis added).

Generally speaking, with regard to "lump sum" contracts, the contractor is recognized as the "end user" of the materials and therefore, is liable for any sales and use taxes owed on the purchased materials.

Regulation 45 IAC 2.2-3-9(e)(3) explains this taxing regime:

> (e) Disposition subject to use tax. With respect to construction materials a contractor acquired tax-free, the contractor is liable for the use tax and must remit such tax (measured on the purchase price) to the Department of Revenue when he disposes of such property in the following manner:
>
>> (3) Lump sum contract. He converts the construction material into realty on land he does not own pursuant to a contract that includes all elements of cost in the total contract price.

The regulatory language, on its face, appears to support Taxpayer's protest. However, an exemption is provided for the taxable disposition discussed in 45 IAC 2.2-3-9(e)(3); the exemption, though, is qualified by the following language:

> A disposition under C. [*subsection (e)(3) of this section]* [i.e., "Lump sum contract"] will be exempt from the use tax only if the contractor received a valid exemption certificate, not a direct pay permit, from the ultimate purchaser or recipient of the construction material (as converted), provided such person could have initially purchased such property exempt for the state gross retail tax.

45 IAC 2.2-3-9(f).

Taxpayer, the "ultimate purchaser or recipient," provided its contractors with exemption certificates. IC 6-2.5-8-8. The contractors, therefore, did not self-assess use tax on the construction materials that it purchased. Audit subsequently discovered the exemption certificates had not been properly issued, as Taxpayer was not a "person [that] could have initially purchased such property exempt for the state gross retail tax." Consequently, liability for use tax lies with Taxpayer, and not its contractors.

<u>FINDING</u>

Taxpayer's protest is denied.

V. <u>Sales and Use Tax</u> – Service and Maintenance Agreements

<u>DISCUSSION</u>

As part of its protest, Taxpayer submitted seven (7) service and maintenance agreements ("Agreements") for the Department to review. Taxpayer explains:

> The following items were not received by the Indiana Auditors during the audit. Copies of the agreements are attached.

Taxpayer's brief—"Issue V: Maintenance Agreements."

After reviewing Taxpayer's submissions and Audit narratives, it is not clear to the Department whether Taxpayer is protesting proposed Audit assessments, or Taxpayer is requesting a refund for sales and use taxes paid in error. Regardless of characterization, Taxpayer "prays" for favorable Audit adjustments.

The Department will forward copies of the Agreements to the Audit Division for further review. Any verified overpayments will be offset to the extent outstanding proposed assessments exist.

FINDING

Taxpayer's protest is sustained to the extent the Department agrees to accept copies of these Agreements for further Audit review.

VI. Sales and Use Tax – Energy Center

DISCUSSION

The Parent corporation operates an "energy center"—a certified resource recovery system—that creates energy for both the Parent and two (2) of its Subsidiaries. The Subsidiaries reimburse their Parent for the operational costs of the center on an allocated cost basis (monthly usage plus a fixed overhead charge). Sales tax was not paid on these energy purchases. Rather, the Subsidiaries self-assessed use tax based on the percentage of nonexempt usage. Audit proposed additional assessments to the extent the energy was not used in production and sales tax had not been paid or use tax self-assessed and remitted to the Department. (See IC 6-2.5-5-5.1.)

Taxpayer offers three (3) arguments in response to Audit's assessments. **First**, even assuming Taxpayer is "selling" energy to its Subsidiaries, Taxpayer contends it is not required to collect sales tax in the absence of a levying statute. Taxpayer directs the Department's attention to IC 6-2.5-4-5 (b) which imposes sales tax on sales of energy by "power subsidiar[ies]" and "person[s] engaged as a public utility." Taxpayer reasons that as a manufacturer, it cannot be classified as a "power subsidiary" or "public utility;" therefore, its "energy sales" cannot be subject to the levying provisions of IC 6-2.5-4-5. Taxpayer notes that no other statute authorizes the collection of sales tax on transactions involving the sale of energy.

Second, Taxpayer introduces *Indiana Dept of Revenue v. Cable Brazil, Inc.*, (1978) 177 Ind.App. 450, 380 N.E.2d 555, (*electrical signal used in furnishing cable television was not tangible personal property*) for the proposition that "energy sources" are not tangible personal property. Accordingly, IC 6-2.5-2-1, which imposes the state gross retail tax on "retail transactions" (i.e., the acquisition of tangible personal property for the purpose of resale and the subsequent transfer of that property to another for consideration, IC 6-2.5-4-1), cannot apply. Similarly, IC 6-2.5-3-2, which imposes use tax on the storage, use, or consumption of tangible personal property if acquired in a retail transaction, cannot apply.

And **third,** Taxpayer argues that even if "energy sources" represented tangible personal property, its transfer, at least in this instance, cannot be attributed to a "retail transaction." Taxpayer explains:

> [The Parent] was not "selling at retail." [The Parent] did not "acquire" tangible personal property for the purpose of retail. Rather, [the Parent] created the energy, as the Department acknowledges in this audit and in the prior letter of findings. Furthermore, [the Parent] did not "sell" the energy, as the Department previously acknowledged as well. [Taxpayer] operate[s] a "unitary" business as the Department has accepted for income tax purposes. [The Parent] was not regularly engaged in the

> sale of the energy in the retail market. It did not offer the energy for sale to the general public at all. To the contrary, it simply generated energy for "its own energy needs."

The Department needs only to ascertain whether the Parent represents a "person engaged as a public utility" within the meaning of IC 6-2.5-4-5 in order to determine the validity of these assessments.

The language of IC 6-2.5-4-5 reads, in part:

> (b) A power subsidiary or **a person engaged as a public utility** is a retail merchant making retail transaction when the subsidiary or person furnishes or sells electrical energy, natural gas, artificial gas, water, steam, or steam heating service to a person for commercial or domestic consumption.
>
> (c) Notwithstanding subsection (b), a power subsidiary **or a person engaged as a public utility** is not a retail merchant making a retail transaction when:
>
>> (3) the power subsidiary or person sells the services or commodities listed in subsection (b) to a person for use in manufacturing, mining, production…. However, this exclusion for sales of the services and commodities only applies if the services are consumed as an essential and integral part of an integrated process that produces tangible personal property and those sales are separately metered for the excepted uses listed in this subdivision, **or if those sales are not separately metered by are predominately used by the purchaser for the excepted uses listed in this subdivision** (emphasis added).

The statute uses the phrase "a person engaged as a public utility" rather than "public utility." The choice of words suggests the statutory language is directed towards "persons" other than "power subsidiaries" and "public utilities." The Department has interpreted this phrase to include all "persons" who are providing services traditionally provided by public utilities. Consequently, for purposes of IC 6-2.5-4-5, a "person engaged as a public utility" is any person providing utility services—without reference to the "person's" business association. The Parent meets this definition.

As a "person engaged as a public utility," the Parent should have collected sales tax on it sales of energy to its two (2) Subsidiaries. However, as each Subsidiary predominantly used the purchased energy for exempted manufacturing activities (85% and 87.6%), each Subsidiary qualifies for the "predominant use " exclusion provided by IC 6-2.5-4-5(c)(3).

FINDING

Taxpayer's protest is sustained.

VII. Sales and Use Tax – Storage and Transportation of Work-in-Process

DISCUSSION

Audit assessed use tax on storage and transportation supplies, and equipment (e.g., pallets, forklift trucks, etc.), which were purchased by either the Parent or its Subsidiaries. Audit denied the Parent and its Subsidiaries use of any of the manufacturing exemptions for these items because, in Audit's opinion, they were used outside of the purchaser's integrated production process.

In support of its findings, Audit cites 45 IAC 2.2-5-8(f)(3) and (4), which states:

> (3) Transportation equipment used to transport work-in-progress or semi-finished materials to or from storage is not subject to tax if the transportation is within the production process.
>
> (4) Transportation equipment used to transport work-in-progress, semi-finished, or finished goods between plants is taxable, if the plants are not part of the same integrated production process.

The Parent and its Subsidiaries file a consolidated return for state income tax purposes. The Parent and its Subsidiaries often transfer work between each other's facilities. Taxpayer has characterized all work transferred between members of its unitary group as "work-in-process." Taxpayer argues that all its transportation equipment used to transfer this "work-in-process" to-and-from members of its unitary group—as well as storage equipment used to "hold" the "work-in-process"—should qualify for manufacturing exemptions.

In support of its position, Taxpayer cites *General Motors v. Dept. of State Revenue*, 578 N.E.2d 399 (Ind.Tax 1991); aff'd 599 2d N.E.588 (Ind. 1992). The *General Motors* court held that packaging materials used to protect parts during delivery from one plant to another were exempt from the gross retail tax. *Id*. at 405. The court's analysis focused on identifying the beginning and end of General Motors' (GM's) integrated production process. The court explained:

> [P]ackaging materials used to transport work in progress parts from <u>GM's component plants</u> to <u>GM's assembly plants</u> would be exempt as an essential and integral part of <u>GM's integrated production process</u> of manufacturing finished automobiles…. [A] determination that an integrated production process ends upon the completion of the actual end product marketed (the *most marketable product*) is wholly consistent with the legislative purposes of the exemption statutes to encourage industrial growth and to avoid tax pyramiding. Accordingly, the court finds GM's packing materials, used in its integrated production process to protect unfinished work in progress transported from one production step to another, exempt from sales/use tax under IC 6-2-1-39 (b) (6) and IC 6-2.5-5-3. *Id* at 405.

For GM, the completed automobile represented its most marketable product; consequently, the scope GM's integrated production process incorporated the work performed at GM's final assembly plant Although the automotive component parts manufactured by GM at its various plants may be *a marketable product*, in the context of GM's business ("[t]he facts of the case as well as previous judicial findings indicate GM's production process is by nature highly integrated"), the court characterized the component parts as *unfinished work in process*. *Id.* at 402.

The Parent compares its situation with that of GM and claims that equipment used to store and transport work-in-process from one Subsidiary to another should be exempt. Taxpayer's common law analysis is faulty.

The *General Motors'* decision stands for the proposition (among others) that the scope of a corporation's (GM's) integrated production process *may extend beyond the boundaries of any one plant (component part plant) or division within a corporation*—especially when the corporation's production process is highly integrated. *General Motors*, however, does not stand, as Taxpayer claims, for the proposition that a corporation's integrated production *process may extend beyond a corporation's own boundaries.* The holding in *General Motors* neither requires nor suggests such an interpretation.

What Taxpayer seeks is the sales/use tax equivalent of the income exemptions/exclusions afforded to corporations filing combined or consolidated returns. (See IC 6-2.1-4-6 and 45 IAC 3.1-1-51 and 52.) Such exemptions/exclusions, however, do not exist. The Department concludes, therefore, that a corporation—whether Parent or Subsidiary— cannot include activities performed by other corporate entities—whether Parent or Subsidiary—when defining the scope of its own integrated production process.

FINDING

Taxpayer's protest is denied.

VIII. Sales and Use Tax – "Production" Equipment

Audit assessed use tax, pursuant to IC 6-2.5-3-2 and 45 IAC 2.2-5-8(d), on Taxpayer's purchase of "production" equipment.

(a) Stretch Wrap Machines
Taxpayer purchased two (2) stretch wrap machines—one located near production lines, the other near a shipping area. Taxpayer explains their utility:

> The [stretch wrap] machines are used to wrap plastic around assemblies in trays with a top and a bottom for the … products and used to wrap plastic around boxes stacked on wooden pallets for the computer products. The individual assemblies … are placed in the compartments within the stackable trays. The trays are between top and bottom pieces, but are not secured in any way. The plastic is stretched around the trays including the top & bottom pieces to hold them together.

Taxpayer reasons since packaging is required for the protection of its manufactured products, and application of the plastic wrap is part of the packaging process, the stretch wrap machines represent an "essential and integral part of its integrated production process."

"[A]n excise tax, known as the use tax, is imposed on the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that transaction." IC 6-2.5-3-2. However, pursuant to IC 6-2.5-5-3(b), "[t]ransactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for his direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property."

Furthermore, 45 IAC 2.2-5-8(d) states that "[d]irect use in the production process begins at the point of the first operation or activity constituting part of the integrated production process and ends at the point that the production has altered the item to its completed form, including packaging, if required."

While packaging materials and equipment, generally, enjoy exempt status; shipping materials and equipment do not. Taxpayer's products are manufactured and individually packaged before being placed into compartments, on stackable trays, and then "stretch wrapped" in preparation for shipment. Shipping is a post-production activity; any equipment used to facilitate shipping that is not part of Taxpayer's integrated production process is subject to Indiana sales and use taxes.

Consistent with the foregoing analysis, Taxpayer's stretch-wrap machine located in its production area may be exempt if used within Taxpayer's integrated production process—i.e., used for packaging manufactured product. In its narrative, Taxpayer distinguishes between its two stretch-wrap machines by location, but not, however, by function. Therefore, absent additional information, the stretch-wrap machine located in the production area, like the stretch-wrap machine used in shipping, will not qualify for exempt treatment.

(b) Smart Sonic Cleaning Station

Taxpayer purchased a smart sonic cleaning station ("cleaning station"). The cleaning station is used to clean stencils. Taxpayer describes the utility of its stencils and cleaning station:

> Stencils are used to force paste through holes on the stencil onto a board. The placement [of the paste] must be very exact, or the parts won't be placed on the boards correctly. Manually during production, the stencils are wiped off. After every shift or change over, the stencil is washed in the cleaning station. If we [Taxpayer] have a misprinted board during a shift, the stencil is washed off immediately in the cleaning station. The equipment [i.e., the cleaning station] removes [paste] clogged holes from stencils [because] [i]f the holes are clogged, the paste will not be applied to the board correctly which will cause poor quality.

Taxpayer seeks one of the industrial exemptions for its cleaning station as it represents an essential and integral part of its integrated production. (See IC 6-2.5-5-3 and 45 IAC 2.2-5-8.)

The Department believes that while the stencils may be characterized as an essential part of Taxpayer's production process, equipment used to **clean** the stencils cannot. Cleaning activities generally, and the cleaning of Taxpayer's stencils particularly, are properly characterized as pre-production and/or post-production activities. As such, Taxpayer may not claim any of the industrial exemptions for its cleaning system.

(c) Smoke Absorbers
Taxpayer claims an exemption for smoke absorbers used to remove fumes from the air during the cleaning of solder pots. Taxpayer explains:

> When using molten solder in solder pots, a buildup of chemicals occurs which must be cleaned out. Tin lead and other chemicals are removed during cleaning and would be emitted into the air if not for the use of the smoke absorbers. Taxpayer is a smoke free environment by necessity. A smoke-filled plant would contaminate the assemblies and adversely affect production workers in the operation.

Taxpayer contends its smoke absorbers represent exempt production machinery because their use allows Taxpayer's workers to participate in the production process.

Regulation 45 IAC 2.2-5-8(c) Ex.2(F) states:

> (2) The following types of equipment constitute essential and integral parts of the integrated production process and are, therefore, exempt.
>
> *******
>
> > (F) Safety clothing or equipment which is required to allow a worker to participate in the production process without injury…

The facts presented indicate that while the smoke absorbers are "essential" to Taxpayer's *cleaning* process, they are not part of its *production* process. The cleaning of production equipment is generally not part of an "integrated production process" as cleaning usually represents pre-production and post-production activities. The Department concludes Taxpayer's smoke absorbers are not an "essential and integral part" of Taxpayer's integrated production process. The smoke absorbers, therefore, are taxable.

(d) Ionographs
Taxpayer purchased ionographs. The ionographs, according to Taxpayer, are used for testing and inspection purposes. Taxpayer describes the utility of its ionographs:

> The ionograph includes a mixture of dionized water and isopropyl alcohol. Each morning and each afternoon, as a matter of standard testing of production, one [item] (manufactured by Taxpayer) is placed in the solution. Contaminates such as salt are washed off the [item] and into the water. The ionograph measures the level of contaminates which come from the [item]. If the contaminates are not within the allowed range of contaminates to be present as prescribed by industry standards…the entire morning or afternoon run would have to be redone. This is a sampling method of testing production to assure product quality.

Taxpayer, invoking the language of 45 IAC 2.2-5-8(i), believes that "because of the functional interrelationship between the testing equipment [i.e., the ionographs] and the machinery on the production line and because of the product flow, the testing equipment is an integral part of the integrated production process and is exempt."

Tangible personal property directly used in the direct production of other tangible personal property is exempt from Indiana sales and use tax. IC 6-2.5-5-3. The scope of this "machinery, tools, and equipment" industrial exemption has been interpreted to include certain types of testing and inspection equipment. As Taxpayer acknowledges, 45 IAC 2.2-5-8(i) provides an exemption for "[m]achinery, tools, and equipment *used to test and inspect the product as part of the production process…"* (emphasis added).

The Department agrees with Taxpayer's analysis. Taxpayer does not use its ionographs to test raw materials—a nonexempt pre-production activity. Nor does Taxpayer use it ionographs to test finished products—a nonexempt post-production activity. Rather, the ionographs are used to test production samples taken from work-in-progress. The Department finds Taxpayer's sampling and testing of manufactured products to be part of Taxpayer's integrated production process. The ionographs qualify for the exemption provided by IC 6-2.5-5-3.

(e) Labels

Taxpayer protests assessments of use tax of its purchase of two (2) types of tags. Taxpayer claims an exemption for these tags under IC 6-2.5-5-5.1(b), which exempts tangible personal property from state sales and use taxes "if the person acquiring the property acquires it for his direct consumption as a material to be consumed in the direct production of other tangible personal property…."

Taxpayer explains the utility of each tag:

> When [raw material] is purchased…[the buyer] places a plastic tag on the [material]. This number will be used to identify the [material] upon arrival and will be used as a reference number throughout our manufacturing process and inventory….Once [material] has been received, [it] will be cut into sections. Another plastic tag with a different color will be placed on each section of the [material]….[W]e are able to track each [section] according to the number assigned. The number acts as a "part number." At any time after a section of [the material] has been tagged, our system can provide information about that section such as which machine centers the [section] has gone through, how much production was yielded, cost, warehouse location, etc.

Taxpayer's identification labels are used outside of Taxpayer's integrated production process; therefore, the labels and do not qualify for any of the industrial exemptions. While accounting, receiving and inventory tracking may represent activities essential to Taxpayer's business, they are not part of its production process.

<u>FINDING</u>

Taxpayer's protest is denied concerning the exemption status of its **(a)** stretch wrap machines, **(b)** smart sonic cleaning machine, **(c)** smoke absorbers, and **(e)** labels. Taxpayer's protest is sustained with regard to the taxability of the **(d)** ionographs.

IX. Sales and Use Tax - "Sharpening" Tools and Equipment

Taxpayer engages in manufacturing, "remanufacturing," and service activities. Taxpayer manufactures saw blades and various types of manufacturing tools. Taxpayer, as a service provider, sharpens saw blades for customers. Additionally, Taxpayer "remanufactures" (Taxpayer's terminology) untipped saw blades. Only the latter activity has resulted in a protested issue.

Audit assessed use tax on Taxpayer's equipment and materials used in "remanufacturing" (i.e., "retipping") activities. Audit characterized Taxpayer's "retipping" activities as one of service—with the effect of denying Taxpayer exemptions for equipment used and materials consumed in "retipping" activities.

Taxpayer briefly describes its "remanufacturing" (i.e., saw "retipping") activities:

> [Taxpayer] remanufactures saw blades owned by customers. When the saw blades are shipped to [Taxpayer], they have no value other than scrap value. In order to remanufacture the blades into tipped saw blades, [Taxpayer] must undertake a complex and substantial process in which [Taxpayer] files, carves and tips, balances, realigns, and calibrates the blades. [Taxpayer] applies carbon tips as well as additional materials of braze and flux to the blades. [Taxpayer] uses computers in this remanufacturing process. An average tip remanufacture adds materials in excess of 10% of the total remanufacturing charge….As a result of [Taxpayer's] remanufacturing, the tipped blades generally are stronger, more durable and functionally better suited to newer applications than the blades as originally manufactured. As a result, the tipped blades generally are better products than the blades as originally manufactured.

Taxpayer argues the materials and equipment used in its "remanufacturing" processes should qualify for the sales and use tax exemptions provided by the equipment exemption (IC 6-2.5-5-3), the consumption exemption (IC 6-2.5-5-5.1), and pursuant to *Rotation Products Corp. v. Indiana Dept. of State Revenue*, 690 N.E.2d 795 (Ind.Tax 1998).

In *Rotation Products*, the Court was asked to determine whether Petitioner was entitled to any of Indiana's industrial exemptions for tangible personal property used and consumed in "remanufacturing" activities. To that end, the Court addressed whether Taxpayer's "remanufacturing" activities constituted "production" of tangible personal property, or represented the provision of services. As prelude to its analysis, the Court offered the following observation:

> An evaluation of whether activity labeled remanufacturing actually constitutes production within the meaning of the industrial exemptions is a fact-sensitive inquiry,

> and there are no bright-line tests.

Id. at 805.

The Court then discussed four factors "germane to this fact-sensitive inquiry." The factors announced were:

> 1) the work performed must be substantial and complex;
>
> 2) the article's value after the work (i.e., "remanufacturing") has been done must be greater than the article's value before the work was commenced;
>
> 3) the utility of the "remanufactured" item should compare favorably with that of a newly manufactured item; and
>
> 4) the work performed should not have been "contemplated as a normal part of the life cycle of the existing article"

Id. at 805, 806.

After applying this four-factor analysis to Taxpayer's "remanufacturing" activities, the Department agrees with Taxpayer's conclusion. Regardless of the characterization of Taxpayer's activities (e.g., servicing, processing, repairing, rebuilding, refurbishing), the work performed by Taxpayer (i.e., saw "retipping") falls within the range of activities that, pursuant to *Rotation Products,* qualify for industrial exemptions.

FINDING

Taxpayer's protest is sustained.

X. Sales and Use Tax – Safety Equipment

DISCUSSION

Taxpayer purchased **safety cans** and **drum vents** both designed, and subsequently utilized, according to Taxpayer, to prevent explosions in the workplace.

"Transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production, manufacture…of other tangible personal property. IC 6-2.5-5-3(b). The Department has adopted regulations in which certain classifications of tangible personal property have been deemed to have met this "double direct" ("essential and integral") standard.

Regulation 45 IAC 2.2-5-8(c)(2) states in part:

> The following types of equipment constitute essential and integral parts of the integrated production process and are, therefore, exempt….
>
> > (F) Safety clothing or equipment which is required to allow a worker to participate in the production process without injury or to prevent contamination of the product during production.

Taxpayer's safety cans are used for storage purposes. Taxpayer's drum vents afford proper ventilation. Such functionality represents non-exempt uses. (see 45 IAC 2.2-5-8(e) and (j).) Additionally, Taxpayer's safety cans and drums vents are too far removed, functionally, from Taxpayer's integrated production process to qualify for the exemption provided by 45 IAC 2.2-5-8(c)(2)(F).

FINDING

Taxpayer's protest is denied.

XI. Tax Administration – Penalty

DISCUSSION

Taxpayer protests the imposition of the ten-percent (10%) penalty. The negligence penalty imposed under IC 6-8.1-10-2.1(e) may be waived by the Department where reasonable cause for the deficiency has been shown by Taxpayer. Specifically:

> The department shall waive the negligence penalty imposed under IC 6-8.1-10-2.1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. 45 IAC 15-11-2(e).

Taxpayer has shown reasonable cause in its interpretation of Indiana sales and use tax law.

FINDING

Taxpayer's protest is sustained.